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OCT 12 1959
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 463

WILLIAM K. WARREN and NATALIE O. WARREN, ET AL.,
Petitioners,

v.

THE UNITED STATES, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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The taxpayers pray that a writ of certiorari issue to review the judgment of the United States Court of Claims, entered on April 8, 1959. Motion for a rehearing was overruled on July 13, 1959, (Appendix A, *infra*, p. 1a)

OPINION BELOW

The opinion of the United States Court of Claims is not yet reported officially but is reported unofficially at 171 F. Supp. 846. Both the majority opinion (Madden, Judge) and the dissenting opinion (Jones, Chief Judge) are printed as Appendices B and C, respectively, *infra*, pp. 2a, 8a.

JURISDICTION

The judgment of the Court of Claims was entered on April 8, 1959. A motion for a rehearing and for relief from the order of the court was filed on May 8, 1959, and was overruled on July 13, 1959, (Appendix A, *supra*). Review by petition for a writ of certiorari is sought pursuant to the provisions of 28 U.S.C. 1255(1).

QUESTION PRESENTED

All of the petitioners were stockholders of a corporation which was liquidated in 1941. Each petitioner was to receive in liquidation a certain amount of cash in 1941, plus an overriding royalty contract providing for future payments. The trial commissioner of the Court of Claims who heard the evidence found that the overriding contracts had no ascertainable fair market value when received in 1941.

In later years, 1949 to 1952, inclusive, the petitioners received deferred payments under those contracts, and the question is whether such deferred payments are taxable at capital gains tax rates or at ordinary income tax rates.

STATUTE INVOLVED

The statute involved is the Internal Revenue Code of 1939, sections 111, 112, 115 and 117, which are set forth in Appendix D, *infra*, p. 12a.

STATEMENT

All of the petitioners were stockholders of The Corpus Christi Corporation which liquidated in 1941. For their stock each received cash (not in dispute) plus an overriding royalty contract entitling

them to possible future payments. For 1941, the petitioners did not treat the overriding royalty contracts as income. They stated in their returns that such royalty interests had no ascertainable fair market value. Thereafter, the Commissioner of Internal Revenue determined that the overriding royalty contracts had a value of $1,035,000, in 1941, and after the stockholders had received this amount any sums received thereafter were taxable as income at ordinary rates. The petitioners acquiesced in this determination through the taxable year 1948, but filed claims for refund for 1949 to 1952, inclusive, on the ground that the determination of the Commissioner was erroneous and that amounts received by petitioners should have been taxed at capital gains rate.

As required in Section 6532 (a)(1) of the Internal Revenue Code of 1954, these claims either had been rejected by the Commissioner of Internal Revenue or had been filed more than six months prior to the institution of these suits in the Court of Claims. In the majority opinion of April 8, Appendix B, *supra,* the Court of Claims sustained the action of the Commissioner of Internal Revenue. In the trial before the Court of Claims the trial commissioner found that:

> "* * * it was impossible to determine the value of such royalties with reasonable accuracy * * *" (Finding No. 32(a) to (h) inclusive.) [R-53, 54]

The majority opinion, Appendix B, *supra,* states:

> "As to the controverted question of whether the plaintiffs' overriding royalties were, in 1941, reasonably susceptible of valuation, we have concluded that the question need not be answered. * * *"

Chief Judge Jones, in his dissenting opinion, Appendix C, *supra*, stated:

> "* * * Where the factors affecting the valuation are so uncertain, contingent, or speculative that the value cannot be determined with reasonable accuracy, it must be held that the oil and gas interests have no fair market value. That is the situation here as found by the trial commissioner who heard and considered all the evidence bearing on the question. The reasons for this finding of lack of any market value at the time of the transfer are set out in findings 30, 31, and 32. For some reason the majority has seen fit to eliminate these findings."

REASONS FOR GRANTING A WRIT

The majority opinion below, which involves an important issue as to how the proceeds from a contract having no fair market value are to be treated as income for tax purposes, is in direct conflict with the ruling of the Court of Appeals for the Second Circuit in *Commissioner* v. *Carter*, 170 F. 2d 911 (Appendix E *infra*, p. 14a), and the ruling of the Court of Appeals for the Ninth Circuit in *Westover* v. *Smith*, 173 F. 2d 90 (Appendix F, *infra*, p. 19a), as well as with various decisions of the U. S. Tax Court; one of the latest being *Hoy* v. *Commissioner*, 17 T.C.M. 115 C.C.H.—T.C.M. 1958-28.[1] The conflict is one of continuing importance under various revenue acts, and widespread litigation will continue until the point is settled by this Court.

(1) As appears on its face, the decision below is in direct conflict with the Second Circuit's decision in

[1] The *Carter*, *Westover* and *Hoy* cases cited and relied upon *Burnet* v. *Logan*, 283 U.S. 404, as being the basis of the **open transaction doctrine** discussed, *infra*, p. 9.

Commissioner v. *Carter*, *supra*. In *Carter*, the taxpayer had owned for ten years all the stock of the corporation which was dissolved in 1942. Upon dissolution of the corporation, all of its assets were distributed in kind. In the distribution, the taxpayer received property having a fair market value in excess of $20,000.00 over the cost basis of her stock, and she reported such excess as a capital gain in her 1942 return and paid tax thereon. In the liquidation she also received 32 oil brokerage contracts which had no ascertainable fair market value when distributed. In 1943, the taxpayer collected commissions of $34,992.20 under the contracts which she reported as a long-term capital gain. The Commissioner determined it to be ordinary income. The Tax Court held it taxable as capital gain, and the Court of Appeals affirmed. Said the Court:

> "The Commissioner argues that the *Logan* case is inapplicable because there the taxpayer had not recovered the cost basis of her stock while here she had. The Tax Court thought the distinction immaterial. We agree. The Supreme Court spoke of the annual payments as constituting "profit" after the seller's capital investment should be returned. Until such return it cannot be known whether gain or loss will result from a sale; thereafter it becomes certain that future payments will result in gain. No reason is apparent for taxing them as ordinary income. As this court said in *Commissioner of Internal Revenue* v. *Hopkinson*, 2 Cir. 126 F. 2d 406, 410, 'payments received by the seller after his basis had been extinguished would have been taxable to him as capital gains from the sale of the property', citing *Burnet* v. *Logan* as authority."

(2) The decision of the Ninth Circuit in the *Westover* case is in accord with the *Carter* case. In *Westover*, the taxpayer owned all the stock of the Quickwork Company, a corporation engaged in the manufacture and sale of machine tools. In 1940, the corporation sold all of its assets in exchange for cash and the right to receive 10 percent of the gross sales price of machinery to be manufactured by the purchaser. The Quickwork Company was thereupon liquidated. The distribution in liquidation netted the taxpayer $39,204.26 in cash and the contract calling for 10 percent of the gross sales made by the purchaser. The adjusted basis of the stock to the taxpayer on the date of liquidation was $34,000.00, and she paid a capital gain tax on the $5,204.26 profit. Payments received by the taxpayer in subsequent years were treated by the Commissioner as ordinary income. The taxpayer contended that the receipt of the 10 percent of the gross sales price of the machinery actually manufactured under the contract was an integral part of the liquidation-distribution and therefore such sums were to be treated as payments in exchange for stock. The court found that the contract had a very substantial value but there was no way of ascertaining its fair market value. The court, in holding for the taxpayer, stated:

> "* * * The payments in this case arose directly out of the contract, which had a substantial value, and may be said to be 'amounts distributed' within the purview of § 115(c), thus falling squarely within the holding in Burnet v. Logan, 283 U.S. 404, 51 S. Ct. 550, 75 L.Ed. 1143. Distributions under § 115(c) are treated in the same manner as sales. In any event, it is clear that the contract itself was a distribution under § 115(c). Its tax-

able valuation is its fair market value, according to § 111(b) of the Internal Revenue Code. *Although there was no ascertainable fair market value at the time of liquidation, we find nothing in the statute requiring the market value to be measured immediately. In such a situation the only practicable and accurate method of measuring the contract's value is through the application of money to such valuation as it is received.* The alternatives are to ascribe a fictitious or speculative value to the property, which was condemned in the Logan case, or to allow it no value, as urged by appellants. Such methods result in inaccuracies and inequities. We think the proper procedure is to measure the value of the contract as payments are received." (Emphasis added)

(3) The Tax Court has consistently adhered to the same ruling. In fact, as late as 1958, it treated the question in a memorandum opinion, *Hoy* v. *Commissioner*, 17 T.C.M. 115, C.C.H.-T.C.M. 1958-28.

In *Hoy*, the taxpayer owned all the stock of Hoy Equipment Co. This Corporation had a contract whereby it was to receive a royalty of 10 percent on all sales of ham molds and loaf molds, etc., made by The Globe Company. On July 31, 1950, the Hoy Equipment Co. was dissolved and liquidated and Hoy received all the assets and assumed the liabilities. Among the assets was the 10 percent royalty contract with Globe. Globe paid Hoy royalties in 1951, 1952 and 1953 the amounts of $29,685.41, $32,844.09, and $32,401.94, respectively.

The Commissioner had found a value for the contract on July 31, 1950, of $123,638.85, and that the amounts subsequently received by Hoy in excess

of that were taxable as ordinary income. On appeal to the Tax Court the taxpayer contended that under the *Logan*, *Carter* and *Westover* cases the royalties received thereafter were additional capital gains from the liquidation.

The Tax Court found that the value of the contract with Globe on July 31, 1950, was not ascertainable, sustained the taxpayer and entered a decision accordingly. No appeal was taken by the Commissioner. Said the Court:

> "The petitioners contend that the value of the Globe contract was not ascertainable on July 31, 1950, and that, pursuant to *Burnet* v. *Logan*, 283 U.S. 404 (1931) [2 USTC ¶ 736], the royalties received thereafter were additional capital gains from the liquidation. This rule has also been applied in *George J. Lentz*, 28 T. C. 1157, [Dec. 22,567]; *J. C. Bradford*, 22 T.C. 1057, (1954) [Dec. 20,511]; *Susan J. Carter*, 9 T. C. 364. (1947) [Dec. 16,015] aff'd 170 Fed. 2d 911 (C.A. 2, 1948) [48-2 USTC ¶ 9415]; and *Westover* v. *Smith*, 173 Fed. (2d) (C.A. 9, 1949) [49-1 USTC ¶ 9189].
>
> * * * *
>
> "There were a number of factors tending to make uncertain any forecast of the sums to be realized from the contract. It was dependent upon future production and sales by a company over which Hoy had no control. It depended upon the extent Globe would utilize the patents which were principal factors in Hoy's business, but only a part of Globe's interests. It was uncertain whether competition or new inventions would depress the sales volume or render the products obsolete. Globe used heavier gauge steel and increased the life of the molds which made replacements less frequent. Hoy believed that employment of De Cressy by Globe was important to main-

tain sales and was willing to pay him a part of the royalty to stay, but it was uncertain how long De Cressy would remain with Globe. In fact he left that employment in 1951. It could not be known whether the parties might agree to reduce the royalty as provided in the contract. Such a reduction did occur in 1955. In view of these uncertainties the valuation proposed by the respondent is, in our opinion, too speculative to stand. We find that the fair market value of the contract was not ascertainable on July 31, 1950."

(4) The decision of this court in *Burnet* v. *Logan*, 283 U.S. 404, is not reconcilable with the opinion below. That case laid down the rule that property has no fair market value when it cannot be valued with a reasonable degree of accuracy; further, that royalties received under a contract having no fair market value are not to be taxed until the taxpayer has recovered his tax basis in the property he sold. In so holding, the Supreme Court established the foundation stone of the **open transaction doctrine** under which a taxpayer is entitled to capital gains treatment on the proceeds subsequently received from a contract having no fair market value when transferred to the taxpayer in exchange for a capital asset. In that case the taxpayer, as part of the consideration for the sale of stock, received a 1/16th interest in a royalty contract providing payment of sixty cents a ton on iron ore to be mined under a 97 year lease from certain property. The Court, in holding that the royalties had no fair market value, stated:

"* * * When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000.00 in cash and the promise of future money payments wholly

> contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one."

The **open transaction doctrine** is well recognized by the Commissioner of Internal Revenue, as shown in Revenue Ruling 58-402,IRB 1958-33, 8, 9, which reads in part as follows:

> "The results, for purposes of capital gains or ordinary income, are that if the sale or exchange remains an open transaction, because of unusual uncertainties with respect to valuations in rare and extraordinary cases, then the subsequent payments received under the contract will be subject to the appropriate capital gains provisions in the statute; * * *"

Doubtless the Commissioner's publication of the foregoing portion of the ruling was occasioned by the numerous court decisions following the open transaction doctrine. (See Appendix G, *infra*, p. 23a, listing 43 such cases.)

Obviously, in such a situation as is now before the Court, it takes little imagination to conclude that the amounts received were from an open transaction and that the gain thereon was a capital gain.

This is not a depletion case as argued by the Government below. The sole issue is whether the proceeds received from the sale of a capital asset are to be taxed at capital gains rates, as we contend, or at ordinary income rates, as the majority opinion below held. There should be no exception to the open trans-

action doctrine or to the principles of the *Logan*, *Carter*, *Westover* or *Hoy* cases, on the ground that in the instant case the taxpayers had a property or "economic interest" in the overriding royalties. Clearly, in the *Logan* case the taxpayer had a property or "economic" interest in the iron ore royalties from a 97 year lease. Certainly the taxpayers had the same type of interest in the properties involved in *Carter*, *Westover* and *Hoy*.

CONCLUSION

In addition to the conflict between the U. S. Court of Claims in the instant case and the Courts of Appeals for the Second and Ninth Circuits, and the cases of the Tax Court and other pending cases, the question involved is one of substantial importance in the administration of the Revenue Laws. This petition for a writ of certiorari should be granted.

Respectfully submitted,

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